Watkins-Johnson Company Annual Report 1979


PHOTOS
TO BE FILED

For Watkins-Johnson Company, 1979 was a year of records. The highest-ever sales, earnings and orders are attributable to one thing—people: people to design, build and deliver innovative, superior products; people to sell products and represent the Company to prospective customers; and people to provide the services—maintenance, plant engineering, purchasing, shipping and receiving, quality assurance, office services, security, and personnel—without which the operating divisions could not run.

The importance of people is particularly evident in years like 1979 when the nation's economy is running near capacity, technology is advancing at a record rate and the competition between firms for qualified employees is intense. Personnel turnovers in the San Francisco Bay area's electronics industry, for example, reached annual rates of more than 30 percent for many companies.

Watkins-Johnson Company has not been immune to the turnover plague, but it has been able to retain key employees and recruit new ones to introduce fresh thinking to the Company as well as build upon the impressive accomplishments of the past. The ability to recruit and retain good employees can play a pivotal role in a company's success in years like these. At W-J, five factors stand out as inducements for fine employees to join . . . and stay.

Challenge. Since its founding, Watkins-Johnson Company has operated at the leading edge of electronic technology. As its product range grew from traveling-wave tubes to include solid-state components, receiving systems and antennas, integrated assemblies, RF and digital testers and production equipment, the Company's challenge to the truly creative and innovative employee has broadened and deepened commensurately.

Opportunity. Through Company-sponsored training and on-the-job experience, the W-J employee enjoys a great potential for professional growth. The policy of reimbursing employees for courses related to their jobs has encouraged the educational advancement of many. Further, the fact that all job openings are first made available to current employees allows each individual great flexibility in the selection of career path within the Company.

Freedom. W-J employees operate in an atmosphere that promotes experimentation and inventiveness. The attitude that imagination must be largely unencumbered by external restraints has resulted in a history of product leadership at Watkins-Johnson. Such leadership is fundamental to the kinds of sales and earnings achieved in years like 1979.

Recognition. Noteworthy accomplishments by W-J employees are rewarded by advancement. The whole job structure of the Company is designed to give the successful employee room to grow. People not only advance within their own job families, but, as additional competence becomes evident, are given leadership positions requiring ever-broader capabilities. Most of W-J's key managers have been promoted from within the Company.

Satisfaction. W-J employees enjoy seeing their efforts result in positive things. Among the successes of 1979 were the winning of a contract to build the U.S. Navy's Noise Jammer Simulator which signals the Company's entry into the active electronic countermeasures systems market, shipment of the first magnetic-bubble memory tester to a major semiconductor manufacturer, continued reliability of the W-J space amplifiers aboard the Pioneer 11 and Voyagers 1 and 2 spacecraft as they performed close-up investigations of Jupiter and Saturn, and the award of a $10 million contract to manufacture 3,000 special-application high-frequency receivers over the next five years.

Thus, the people of W-J enjoy a close and mutually beneficial relationship with their Company and it is on this basis that the successes of the future will be achieved.

To Our Shareowners:

1979 was a year of improvement and progress for your Company. Sales at $127,646,000 were up 21 percent from the $105,618,000 of 1978. Earnings were up even more: $7,254,000 and $2.32 per share on 3,131,219 average shares outstanding compared to $2,173,000 and $.70 on 3,087,144 average shares for the year earlier, a substantial gain even considering that 1978 was adversely affected by a 39 cent per share net loss on a terminated contract.

The total firm order backlog on December 31, 1979 was $82,589,000, down 11 percent from the $92,573,000 at the end of 1978. The portion of the current backlog shippable within one year is 92 percent, compared with 94 percent so shippable at the end of last year.

Shareowners' equity on December 31, 1979 was $59,947,000, up from last year's $52,830,000. Working capital totaled $46,568,000, up almost $8 million from the $38,720,000 at the end of 1978.

Some of the highlights of 1979 were:

1979 Payment of the Company's twenty-first through twenty-fourth consecutive quarterly cash dividends, each in the amount of ten cents per share. The dividends were paid on March 29, June 28, September 27 and December 27.

1979 Foreign sales amounting to 27 percent of total sales. Thirty-one percent of 1978's total sales came from the Company's international customers.

1979 Completion of plans for the construction of a new 80,000-square-foot building at the Company's Santa Cruz plant. Construction is scheduled to begin during the first quarter of 1980, with completion planned for March 1981.

1979 Decision to expand our overseas facilities by agreeing to purchase a new 10,000-square-foot plant in Windsor, England. Occupancy is expected in the third quarter of 1980.

1979 Creation of approximately 100 new products as the result of research and development efforts during the year. In addition to customer funds, your Company devoted $7,917,000, or 6 percent of sales, to R & D activities in 1979. Some of the new products developed were the WJ-C85-1 RF Processor which was designed for advanced missile applications and offers substantial breakthroughs in performance and miniaturization; the WJ-1292 Synthesized RF Signal Generator that provides stable RF output across the broad 0.1 to 18.0 GHz band in a single chassis with no plug-ins required; the WJ-5270 Multioctave Tunable Filter which achieves a 400 MHz minimum instantaneous 3-dB bandwidth using spheres manufactured from single-crystal lithium-zinc ferrite grown by W-J; the WJ-984 Microprocessor-based Temperature Controller which contributes unusual accuracy, versatility and reliability to the Company's conveyor furnace line; a prototype frequency memory loop for an advanced airborne system by which the Company demonstrated technical competence within a demanding schedule; the WJ-8616 VHF/UHF Scanning Receiver that combines microprocessor control with advanced receiver technology and can be used alone or as part of a larger system; the WJ-AR7-18 Log-Periodic Antenna which covers the full 1 to 18 GHz frequency range, is housed in a waterproof fiberglass radome and provides a clean profile and rugged durability for airborne, shipboard or ground-based installations; the WJ-PA12 Cascadable Amplifier which supplies power outputs in excess of +23 dBm over the 10 to 1200 MHz frequency range; the WJ-4700 series of Active ECM Equipment designed to simulate all known deceptive and noise techniques in the 0.5 to 18.0 GHz frequency range; the WJ-5323 Solid State Amplifier which uses a gallium-arsenide field-effect transistor (GaAs FET) produced by W-J to deliver +20 dBm of output power across the 12 to 18 GHz frequency range; the WJ-9071 RF Test Generator that serves as a signal source providing a comb of RF signals between 160 MHz and 12.56 GHz and an input which can be frequency modulated with baseband video up to 8 MHz; the WJ-3606-1 and WJ-3201-2 medium-power glass Traveling-Wave Tubes which were designed as replacements for specific metal-ceramic tubes and have significant business potential over the next few years; an electronic intelligence collection system with integral antenna system which covers the entire 50 MHz to 18 GHz range and allows signals to be analyzed in real time or stored on magnetic tape for off-line processing; and the WJ-2835 series of thin-film and digitally tuned I/J band Voltage-Controlled Oscillators that offer superior performance in lightweight, rugged packages.

As in the past, your Company continued a very active recruitment program, which resulted in the addition of many new scientists and engineers to the Technical Staff during the year. We expect significant contributions from them in the future.

We extend our sincerest thanks and appreciation to all of our employees, who deservedly are the subject of this year's Annual Report, for their accomplishments last year and their continuing loyalty to the Company.

As we write this report to you, we are both encouraged and challenged: encouraged by the progress made last year plus the growing awareness in the Administration and Congress of the need to increase our defenses; challenged by the need to obtain more orders, especially for systems products, in the near term, and by the necessity to continue to work diligently to offset the threat to our margins inherent in the ongoing rapid rise in costs and the chronic shortage in most of the categories of labor we employ, especially in our plants in the Santa Clara Valley.

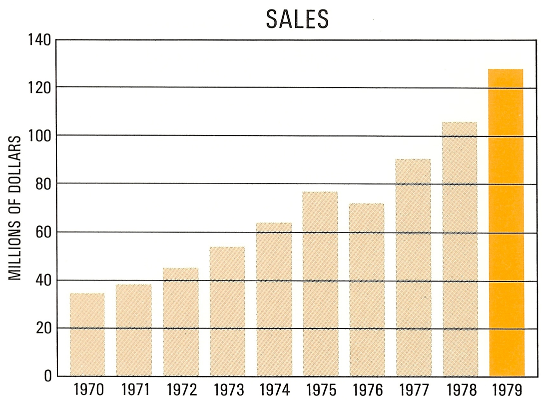
Overall, we expect to continue to make good progress this year.

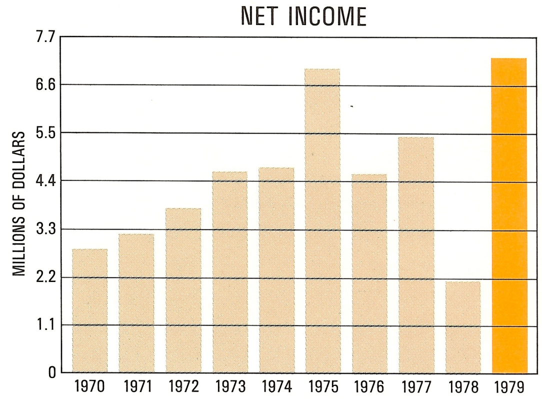
Dean A. Watkins — Chairman of the Board

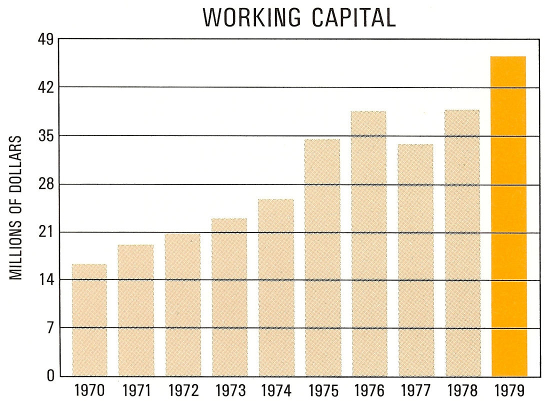
H R Johnson — President and Chief Executive Officer

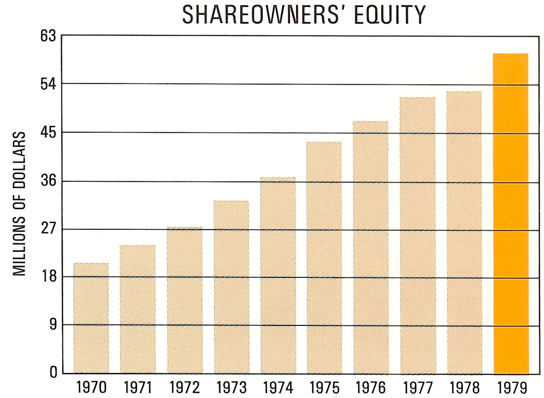
February 29, 1980

10 Years Performance









Highlights from Previous Annual Reports

		1979	1978	1977	1976	1975	1974	1973	1972	1971	1970
OPERATING RESULTS	Sales	$127,646,000	$105,618,000	$90,071,000	$71,982,000	$76,828,000	$63,630,000	$53,625,000	$45,181,000	$38,081,000	$34,444,000
	Net Income	7,254,000	2,173,000	5,440,000	4,566,000	6,985,000	4,723,000	4,610,000	3,790,000	3,213,000	2,842,000
	Earnings Per Share	$2.32	$ .70	$1.76	$1.48	$2.28	$1.55	$1.52	$1.26	$1.07	$ .95
FINANCIAL POSITION	Working Capital	$ 46,568,000	$ 38,720,000	$33,941,000	$38,520,000	$34,455,000	$25,790,000	$23,049,000	$20,915,000	$18,966,000	$16,145,000
	Total Assets	108,175,000	92,411,000	84,046,000	76,866,000	73,807,000	57,318,000	45,905,000	39,484,000	35,360,000	31,385,000
	Shareowners' Equity	59,947,000	52,830,000	51,778,000	47,316,000	43,680,000	36,709,000	32,228,000	27,670,000	23,851,000	20,457,000
GENERAL STATISTICS	Average Number of Shares Outstanding	3,131,219	3,087,144	3,082,878	3,082,548	3,066,710	3,037,390	3,023,972	3,019,145	2,996,933	3,002,105
	Number of Employees at Year End	2,920	2,930	2,710	2,240	2,270	2,090	1,910	1,730	1,420	1,320
	Number of Shareowners at Year End	4,800	5,000	5,300	4,900	4,800	4,500	4,400	4,500	6,500	7,500

The figures shown above are taken from previous annual reports, after adjustment giving effect to capitalization of leases on a retroactive basis occurring in 1977.

Consolidated Balance Sheet

For the Years Ended December 31, 1979 and 1978

	1979	1978
CURRENT ASSETS:		
Cash	$ 5,121,594	$ 1,106,364
Marketable securities	10,374,541	2,886,419
Receivables:		
Trade	23,937,946	19,609,514
Unbilled contracts	9,395,512	7,255,499
Terminated contract — net	1,819,943	2,408,642
Income taxes		1,577,259
Inventories:		
Finished goods	548,241	608,206
Work in process	13,631,925	13,901,560
Raw materials and parts	4,110,346	3,136,393
Other	1,482,825	1,155,830
Total current assets	70,422,873	53,645,686
PROPERTY, PLANT AND EQUIPMENT:		
Land	1,275,516	1,275,516
Buildings and improvements	12,961,585	12,798,747
Plant facilities, leased	17,513,732	17,513,732
Machinery and equipment	26,175,037	22,856,502
Construction in progress	68,407	86,716
Total	57,994,277	54,531,213
Accumulated depreciation and amortization	(24,162,019)	(19,872,090)
Property, plant and equipment — net	33,832,258	34,659,123
OTHER ASSETS:		
Notes receivable	3,919,447	4,106,371
	$108,174,578	$92,411,180

LIABILITIES AND SHAREOWNERS' EQUITY

	1979	1978
CURRENT LIABILITIES:		
Notes payable	$ 422,114	$ 136,662
Accounts payable	3,898,583	3,896,273
Advances on contracts	1,645,037	2,123,052
Income taxes	5,954,429	
Payroll and profit sharing	6,704,147	4,255,330
Guarantee under terminated contract	1,875,311	1,875,311
Other	3,355,386	2,638,992
Total current liabilities	23,855,007	14,925,620
LONG-TERM OBLIGATIONS	22,968,679	23,304,376
DEFERRED INCOME TAXES	1,403,498	1,351,506
SHAREOWNERS' EQUITY:		
Preferred stock, $1.00 par value — authorized and unissued, 500,000 shares		
Common stock, no par value — authorized, 15,000,000 shares; outstanding: 1979, 3,171,157 shares; 1978, 3,090,799 shares	3,318,128	3,237,770
Additional paid-in capital	4,723,977	3,687,992
Retained earnings	51,905,289	45,903,916
Total shareowners' equity	59,947,394	52,829,678
	$108,174,578	$92,411,180

See notes to consolidated

Consolidated Statement of Income

For the Years Ended December 31, 1979 and 1978

	1979	1978
Sales	$127,645,731	$105,617,907
Costs and expenses:		
Cost of goods sold	80,634,707	70,208,036
Selling and administrative	25,319,598	21,333,009
Research and development	7,916,552	6,956,828
Loss from terminated contract		2,893,643
Total	113,870,857	101,391,516
Income from operations	13,774,874	4,226,391
Other income (expense):		
Interest and other income — net	1,205,270	709,112
Interest expense	(2,266,325)	(1,987,136)
Income before Federal and foreign income taxes	12,713,819	2,948,367
Federal and foreign income taxes	5,460,000	775,000
Net income	$ 7,253,819	$ 2,173,367
Net income per share	$2.32	$.70

Consolidated Statement of Shareowners' Equity

	Common Stock	Additional Paid-in Capital	Retained Earnings	Total Shareowners' Equity
Balance, January 1, 1978	$3,230,022	$3,582,245	$44,965,531	$51,777,798
Net income for 1978			2,173,367	2,173,367
Cash dividends — $.40 per share			(1,234,982)	(1,234,982)
Sales under employee stock option plan — 7,748 shares	7,748	105,747		113,495
Balance, December 31, 1978	3,237,770	3,687,992	45,903,916	52,829,678
Net income for 1979			7,253,819	7,253,819
Cash dividends — $.40 per share			(1,252,446)	(1,252,446)
Sales under employee stock option plan — 80,358 shares	80,358	1,035,985		1,116,343
Balance, December 31, 1979	$3,318,128	$4,723,977	$51,905,289	$59,947,394

financial statements.

Consolidated Statement of Changes in Financial Position

For the Years Ended December 31, 1979 and 1978

	1979	1978
SOURCE OF FUNDS:		
Operations:		
Net income	$ 7,253,819	$ 2,173,367
Depreciation and amortization	4,527,809	3,920,494
Deferred income taxes	51,992	(12,874)
Provided from operations	11,833,620	6,080,987
Proceeds from long-term obligations		7,200,000
Sale of common stock to employees	1,116,343	113,495
Other	226,374	235,377
Total	13,176,337	13,629,859
USE OF FUNDS:		
Additions to property, plant and equipment	3,740,394	7,263,617
Cash dividends	1,252,446	1,234,982
Payments on long-term obligations	335,697	352,295
Total	5,328,537	8,850,894
INCREASE IN WORKING CAPITAL	$ 7,847,800	$ 4,778,965

	1979	1978
Change in working capital consisted of:		
Increase (decrease) in current assets:		
Cash and marketable securities	$11,503,352	$ (2,296,988)
Receivables	4,302,487	4,661,045
Inventories	644,353	3,130,070
Other	326,995	(236,877)
Total	16,777,187	5,257,250
Increase (decrease) in current liabilities:		
Notes payable	285,452	(731,432)
Accounts payable and accruals	3,167,521	1,893,119
Advances on contracts	(478,015)	903,978
Income taxes	5,954,429	(1,587,380)
Total	8,929,387	478,285
Increase in working capital	$ 7,847,800	$ 4,778,965

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation — The consolidated financial statements include those of the Company and its wholly owned subsidiaries after elimination of intercompany balances and transactions.

Translation of Foreign Currency Amounts — Foreign operations' account balances are translated using year-end exchange rates for current assets and liabilities, and the rate prevailing at time of acquisition for property, equipment, and related depreciation. Income and expense items, except for depreciation, are translated at weighted average rates of exchange prevailing during the year. Resulting exchange adjustments, which were not material, have been reflected in income.

Marketable Securities — Interest bearing investments are valued at cost and accrued interest which approximates market value.

Receivables — Unbilled contracts receivables are recorded when sales are recognized for long-term contracts under the percentage-of-completion method. Reductions in these receivables occur when invoices for products shipped or progress billings are rendered.

Receivables representing retainage and amounts expected to be collected after one year are not material.

Inventories — Inventories are stated at the lower of cost, using first-in, first-out and average-cost basis, or market. Cost of inventory items is based on purchase and production cost; market is not in excess of net realizable value.

Property, Plant and Equipment — Property, plant and equipment are stated at cost. Leases which essentially assure the lessor full recovery of the fair market value of the property over the lease term are capitalized. Provision for depreciation and amortization is primarily based on the sum-of-the-years digits and declining-balance methods.

Sales Recognition on Long-term Contracts — Sales are primarily recorded based on the percentage-of-completion method.

Income Taxes — The consolidated statement of income includes provisions for deferred income taxes for transactions that are reported in one period for financial statement purposes and in another period for income tax purposes. Deferred income taxes are provided on the earnings of the Domestic International Sales Corporation (DISC). Federal income tax expense is reduced by the investment tax credit allowed on property placed in service during the year. State and local income taxes, amounting to $1,018,000 for 1979 and $293,000 for 1978, are included in selling and administrative expenses.

Net Income Per Share — Net income per share is computed using the weighted average number of common shares outstanding during the year. The computation excludes outstanding stock options as their dilutive effect is not material.

2. LOSS FROM TERMINATED CONTRACT

In December, 1978 the Company notified the government of Iran, its customer, that work was being halted on its nearly completed long-term contract of $18,753,000 due to the default of the customer's performance of the contract. The Company took this action since the customer was significantly behind in meeting the progress payment requirement established by the contract. During the years 1977 and 1978 the customer paid the Company $13,245,000 of the recorded sales of $16,672,000. The Company's expectations for resumption of work are not good since the customer's ability to pay has diminished with the increasing political turmoil and other problems currently facing this government. A substantial amount of special designed communication equipment remained on-hand and will not be shipped to the customer. This equipment can be sold with some additional modifications. The net residual value of this equipment, which the Company has estimated at $2,408,000, was used to reduce the overall loss and is shown as Receivables, Terminated Contract-net in the financial statements. In addition, the Company remains contingently liable for a stand-by letter of credit in the amount of $1,875,000 furnished to satisfy the guarantee of performance provision contained in the contract. Because of the above uncertainties, a net write-off totaling $2,894,000 was recorded in December, 1978 for the uncollectible receivables and the letter of credit on this terminated contract. For the fourth quarter and for the year 1978, net income was reduced 39 cents per share as a result of the above write-off after allowing for related reductions in profit sharing and income tax provisions.

During 1979, Receivables, Terminated Contract-net has been reduced $588,000 reflecting the purchase of the equipment by other customers.

In 1979, the Company obtained an injunction in the United States District Court requiring the Iranian bank which holds the letter of credit for the benefit of the Iranian government to give ten day's notice prior to making any claim against the above stand-by letter of credit. In another action, suit against the government of Iran was filed in December, 1979 in the United States District Court seeking damages incurred by the Company for breach of this contract. The Court has granted a writ of attachment applicable to specific assets, including the stand-by letter of credit referenced above.

Continued on the following page

Notes to Consolidated Financial Statements

Under this contract, which is expressly made subject to both Iranian and United States laws and which provides that to the extent there is any difference between the two laws the Iranian law will govern, in legal counsel's opinion the customer's failure to make progress payments in accordance with the contract provisions is a substantial breach of contract, and such breach should eliminate assessment of any significant additional liabilities against the Company. Therefore, the Company believes that the final resolution of this situation should not have any additional material adverse effect on its consolidated financial position or results of operations.

3. LONG-TERM OBLIGATIONS

Mortgage — The San Jose, California plant, which cost $9,600,000, is pledged as security on a mortgage bearing 8¾% interest. The annual payments totaling $710,000 continue into the year 2003 and are payable in monthly installments. At December 31, 1979, the balance was $7,064,000, of which the current portion, totaling $96,000, is included in current liabilities.

Leases — Long-term leases for plant facilities are treated as capital leases for financial purposes. The leases expire during the years 1994 to 2006, however renewal options provide for lease extensions ranging from twenty-four to thirty-five years at revised rental terms, and some include options to purchase property at fair market value. Payment obligations under these capitalized leases and related present value as of December 31, 1979 are as follows:

Lease payments:	
1980-1984 ($1,691,400 per year)	$ 8,457,000
Remaining years	34,064,000
Total	42,521,000
Interest cost	(26,282,000)
Present value of lease payments (current portion, $238,000)	$16,239,000

Rent expense for property and equipment relating to operating leases is as follows:

	1979	1978
Real property	$ 161,000	$ 205,000
Equipment	961,000	950,000
Total	$1,122,000	$1,155,000

Financing for a certain leased facility was provided by the Company. Included in Other Assets-Notes Receivable is the non-current portion of a 7½% deed of trust note of $3,807,000 and $3,888,000 at December 31, 1979 and 1978, which is collectible monthly through the year 1999.

4. SHAREOWNERS' EQUITY

The 1976 Employee Stock Option Plan provides for future grants to certain key employees and officers. The options are granted at the market price on date of grant and are exercisable cumulatively as to one-third the number of shares in each of the third, fourth and fifth succeeding years, and they expire at the tenth anniversary date. The options contain substitute stock appreciation rights under which provision the Company may pay any combination of cash or stock to the optionee for the appreciation in the market price since the date of grant. The appreciation is recognized as compensation and is charged against income. These charges totaled $322,000 in 1979. A summary of stock option transactions follows:

	1979	
	Shares	Price
Granted	4,250	$19.50 to $29.50
Exercised	500	$23.88
Terminated	2,800	
Outstanding at December 31	49,600	$19.50 to $29.50
Reserved for future grants at December 31	249,900	

	1978	
	Shares	Price
Granted	16,550	$20.38 to $21.75
Terminated	1,300	
Outstanding at December 31	48,650	$20.38 to $23.88
Reserved for future grants at December 31	251,350	

The previous Employee Stock Option Plan provides for the sale of common stock relating to commitments under previous grants issued to certain key employees and officers. The options, which were granted at market price on date of grant, are exercisable cumulatively as to one-third the number of shares in each of the third, fourth and fifth succeeding years, and they expire at the fifth anniversary date. Options outstanding at December 31, 1979 totaled 23,607 shares with an exercise price per share ranging from $20.13 to $31.75 and at December 31, 1978 totaled 108, 926 shares with exercise price per share ranging from $12.25 to $34.88.

5. INCOME TAXES

The provision for Federal and foreign income taxes consists of the following:

	1979	1978
Current (less investment tax credit of $341,000 and $498,000)	$5,668,000	$ 474,000
Deferred:		
DISC	440,000	285,000
Capitalized leases	(165,000)	(193,000)
Franchise tax	(302,000)	246,000
Other	(181,000)	(37,000)
Total	$5,460,000	$ 775,000

The differences between the effective income tax rate and the statutory Federal income tax rate are as follows:

	1979	1978
Statutory Federal tax rate	46.0%	48.0%
Reductions in taxes due to:		
Investment tax credit	(2.7)	(16.9)
Other	(.4)	(4.8)
Effective income tax rate	42.9%	26.3%

6. CONTINGENT LIABILITIES

The Renegotiation Act terminated on September 30, 1976; thus the Vinson-Trammel Act, enacted in 1934, applies to certain sales from 1976 through 1979. Renegotiation has been completed for all years through 1975. While there is no assurance that refunds will not be claimed by the United States Government for these years, the Company believes that profits realized on these sales are not excessive and that refunds, if any, should not have a material effect on earnings.

Certain sales of the Company are subject to price revisions by appropriate Government agencies. Refunds, if any, which might arise from subsequent reviews are indeterminate and, in the opinion of management, no material refunds will be required.

Various suits and claims arising in the ordinary course of business are pending against the Company. In the opinion of management, any liabilities which may arise from such actions would not have a material effect on the consolidated financial position or results of operations.

See Note 2 for discussion of loss from terminated contract.

7. BUSINESS SEGMENT REPORTING

The Company operates primarily in one industry: the design, development, manufacture, sale and service of advanced electronic systems and devices for military, industrial and space applications. The majority of the Company's sales are made to governmental agencies and to customers also engaged in national defense.

Sales by geographic areas are as follows:

	1979	1978
United States	$ 93,300,000	$ 73,000,000
Export sales:		
European	6,600,000	5,200,000
Middle East	9,200,000	16,800,000
Other	8,100,000	3,800,000
European foreign operations	10,400,000	6,800,000
Total	$127,600,000	$105,600,000

Foreign operations' assets are less than ten percent of consolidated assets.

Direct sales to government agencies are as follows:

	1979	1978
United States	$36,700,000	$21,700,000
Foreign	18,100,000	23,900,000

8. QUARTERLY FINANCIAL DATA—UNAUDITED

Unaudited quarterly financial data for the years ended December 31, 1979 and 1978, stated in thousands of dollars except per share amounts, are as follows:

	1979 Quarters			
	1st	2nd	3rd	4th
Sales	$31,453	$32,744	$31,149	$32,300
Gross profit	11,258	12,368	11,549	11,836
Net income	1,584	2,184	1,631	1,855
Net income per share	$.51	$.70	$.52	$.59

	1978 Quarters			
	1st	2nd	3rd	4th
Sales	$25,130	$26,056	$26,865	$27,567
Gross profit	8,606	9,195	9,066	8,543
Net income (loss)	708	842	874	(251)
Net income (loss) per share	$.23	$.27	$.29	$(.09)

The fourth quarter of 1978 includes a loss from a terminated contract of $2,894,000 (see Note 2). This quarter was favorably impacted by the cumulative adjustment of the annual effective tax rate from 43% to 26% primarily as a result of the foregoing loss and lower earnings. (See Note 5)

Report of Management

The financial statements of Watkins-Johnson Company and consolidated subsidiaries were prepared by management, which is responsible for their integrity and objectivity. The statements were prepared in conformity with generally accepted accounting principles and, as such, include amounts that are based on the best judgments of management.

The system of internal controls of the Company is designed to provide reasonable assurance that assets are safeguarded and that transactions are executed in accordance with management's authorization and are reported properly. Perhaps the most important safeguard for shareowners in this system is that the Company has long emphasized the selection, training and development of professional accounting managers to implement and oversee the proper application of its internal controls and the reporting of management's stewardship of corporate assets and maintenance of accounts in conformity with generally accepted accounting principles.

Deloitte Haskins & Sells, independent public accountants, are retained to provide an objective, independent review as to management's discharge of its responsibilities insofar as they relate to the fairness of reported operating results and financial position. They obtain and maintain an understanding of the Company's accounting and financial controls, and conduct such tests and related procedures as they deem necessary to arrive at an opinion on the fairness of the financial statements.

The Audit Committee of the Board of Directors, composed solely of Directors from outside the Company, meets periodically, separately and jointly, with the independent public accountants and representatives of management to review the work of each. The functions of the Audit Committee include recommending the engagement of the independent public accountants, reviewing the scope and results of the audit and reviewing management's evaluation of the system of internal controls.

Dean A. Watkins

Dean A. Watkins
Chairman of the Board

Donald E. Schaefer

Donald E. Schaefer
Controller

Report of Independent Accountants

The Shareowners and
Board of Directors of
Watkins-Johnson Company:

We have examined the consolidated balance sheets of Watkins-Johnson Company and subsidiaries as of December 31, 1979 and 1978 and the related consolidated statements of income, shareowners' equity, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, such financial statements present fairly the financial position of the companies at December 31, 1979 and 1978 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins & Sells

February 6, 1980

Business

Watkins-Johnson Company is a technologically oriented company engaged primarily in the design, development, manufacture, sale and service of advanced electronic systems and devices (components) for military, industrial and space applications. The Company's products are used by the reconnaissance, surveillance, communications, telemetry, semiconductor, frequency measurement and testing markets.

Consolidated Summary of Operations*

	1979	1978	1977	1976	1975
Sales	$127,646,000	$105,618,000	$90,071,000	$71,982,000	$76,828,000
Cost of Goods Sold	80,635,000	70,208,000	56,341,000	44,083,000	44,927,000
Selling and Administrative Expense	25,320,000	21,333,000	17,716,000	15,275,000	14,788,000
Research and Development Expense	7,916,000	6,957,000	5,866,000	4,381,000	3,972,000
Loss from Terminated Contract		2,894,000			
Income from Operations	13,775,000	4,226,000	10,148,000	8,243,000	13,141,000
Interest and Other Income — Net	1,205,000	709,000	782,000	1,147,000**	704,000
Interest Expense	2,266,000	1,987,000	1,615,000	1,696,000	1,128,000
Income before Federal and Foreign Income Taxes	12,714,000	2,948,000	9,315,000	7,694,000	12,717,000
Federal and Foreign Income Taxes	5,460,000	775,000	3,875,000	3,128,000	5,732,000
Net Income	7,254,000	2,173,000	5,440,000	4,566,000	6,985,000
Earnings Per Share	$2.32	$.70	$1.76	$1.48	$2.28

*Years prior to 1977 have been restated for the effect of capitalizing leases in accordance with Statement of Financial Accounting Standards No. 13.
**Includes a gain on real property of $441,000 which increased earnings per share by ten cents.

Sales By Product Line

	1979	1978	1977	1976	1975
Systems	58%	56%	54%	49%	54%
Devices	42%	44%	46%	51%	46%

Management's Discussion and Analysis of the Consolidated Summary of Operations

1979 Compared to 1978

Sales increased 21% in 1979 mainly as a result of greater unit volume, although increases in selling prices contributed to the growth. Cost of goods sold increased only 15% due to improved productivity. However, compared to prior years' experience, it should be noted that 1978 cost of goods sold was high in relation to sales. The selling and administrative expense increase of 19% was in line with planned levels and reflects the growth of sales. Research and development expense increased 14% in accordance with plans made for the year. As a result of the above factors and the previous year's operating results being impacted by a major loss on a terminated contract, income from operations increased extraordinarily in 1979. The increase in interest and other income-net resulted from substantial growth in both the funds available for investment and rates of interest earned. The interest expense increase reflects costs for a full year's interest applicable to the long-term financing of the San Jose plant. The significant increase in income before taxes caused the effective federal tax rate to return to a more normal percent of income in 1979.

1978 Compared to 1977

Sales increased 17% in 1978 principally as a result of improved unit volume, but also from increased selling prices. This sales increase was significantly below anticipated growth for the year. Cost of goods sold increased 25% primarily due to the level of productivity being below expectations, the engineering and development content on certain projects being greater than estimated, and also from increased labor and material costs. The selling and administrative expense increase of 20% reflects the continuation of these operations at planned levels. The research and development expense increase of 19% was in accordance with projections made for the year. The loss from a terminated contract resulted from a customer's breach of contract when it failed to make progress payments in accordance with contract provisions as explained in Note 2 to the financial statements. Income from operations decreased 58% as a result of the above factors when compared to 1977. Interest expense increased 23% primarily due to new long-term financing obtained for the San Jose plant. The significant decrease in the effective federal tax rate results primarily from investment tax credit, received on equipment purchases, which was used to reduce the tax computed on this year's low earnings.

Dividends and Stock Prices

1979		1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
Cash Dividends Paid		$ .10	$ .10	$ .10	$ .10
Stock Price (NYSE—Composite Close)	High	23⅝	24¾	29⅜	32½
	Low	15¾	20⅞	23½	21⅛

1978		1st Qtr	2nd Qtr	3rd Qtr	4th Qtr
Cash Dividends Paid		$ .10	$ .10	$ .10	$ .10
Stock Price (NYSE—Composite Close)	High	21½	23¼	26⅛	24⅛
	Low	18½	17⅝	20⅝	15

Shareowners desiring a copy of the Company's annual report on form 10-K may obtain one by writing to the Manager, Shareowner Relations, at the Company's address shown on the back cover of this report.

DIRECTORS

DR. DEAN A. WATKINS
Chairman

DR. H. RICHARD JOHNSON
President of the Company

DWIGHT M. COCHRAN
Personal Investments

DR. FREDERICK E. TERMAN
Vice President and Provost Emeritus, Stanford University

JOHN J. HARTMANN
Financial Consultant

NATHAN C. FINCH
Counsel, Finch, Sauers, Player and Bell

DR. RITA R. CAMPBELL
Senior Fellow, Hoover Institution

JACK L. SHEPARD
Chairman, Granger Associates

OFFICERS

DR. DEAN A. WATKINS
Chairman of the Board

DR. H. RICHARD JOHNSON
President and Chief Executive Officer

DR. O. THOMAS PURL
Vice President, Systems Group

DR. W. KEITH KENNEDY, JR.
Vice President, Devices Group

BRUCE G. BLEECKER
Vice President

BERNARD ROSEN
Vice President

DR. WILLIAM E. KUNZ
Vice President

JOHN H. FOSTER
Vice President

C. LOUISE BEER
Secretary

H. EDWARD BECKMEYER
Treasurer and Assistant Secretary

DONALD E. SCHAEFER
Controller

DUNCAN CURRY, III
Assistant Secretary

CARL L. AVELAR
Assistant Secretary

JOHN S. WILBURN, JR.
Assistant Secretary

ARTHUR A. WENDERING
Assistant Treasurer

GROUPS

Systems Group
Devices Group

SUBSIDIARIES

Watkins-Johnson Associates
Watkins-Johnson International
Watkins-Johnson Italiana, S.p.A.
Watkins-Johnson Limited

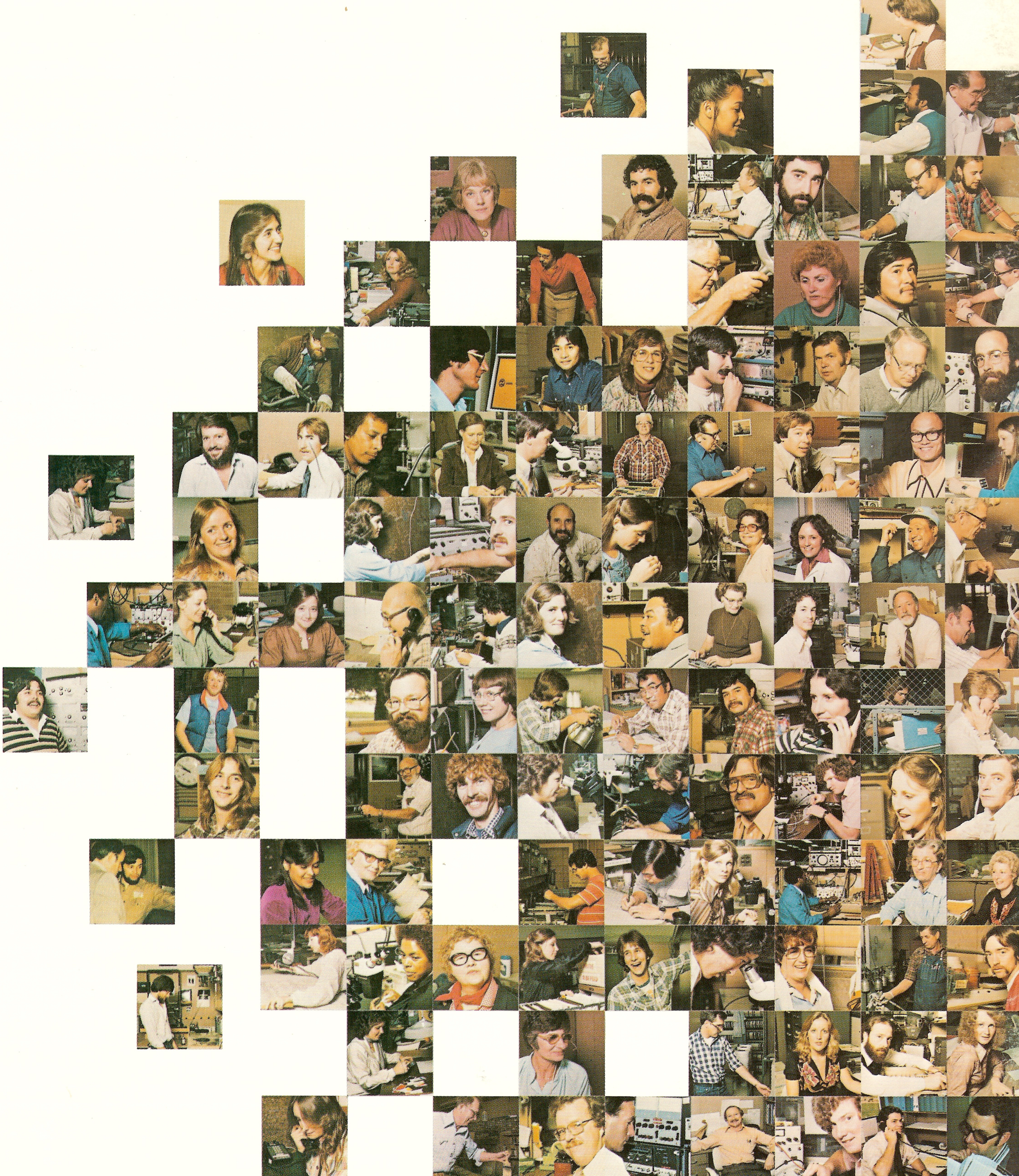
TRANSFER AGENTS/REGISTRARS

Wells Fargo Bank
Morgan Guaranty Trust Company

STOCK EXCHANGES

New York, Pacific, Boston and Philadelphia-Baltimore-Washington
Symbol: WJ

WATKINS-JOHNSON COMPANY
Stanford Industrial Park
3333 Hillview Ave., Palo Alto, CA 94304



WATKINS-JOHNSON

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